

allowed as a deduction under section 274(n), and working condition fringe benefit treatment for expenses for club dues and spousal travel that are disallowed as a deduction under sections 274(a)(3) and 274(m)(3). The final regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993. The persons affected by the final regulations are persons who provide or receive the use of business meals and entertainment, club membership dues, or spousal travel expenses.

EFFECTIVE DATE: These regulations are effective May 30, 1996.

FOR FURTHER INFORMATION CONTACT: Concerning regulations under sections 62 and 132, David N. Pardys, (202) 622-6040; concerning regulations under section 274, John T. Sapienza, Jr., (202) 622-4920 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On December 16, 1994, a notice of proposed rulemaking relating to payment by an employer of expenses for business meals and entertainment, club dues, and spousal travel was published in the **Federal Register** (59 FR 64909 [IA-17-94; EE-36-94, 1995-1 C.B. 942]). A public hearing was held on April 14, 1995.

Written comments responding to the notice were received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision. The significant comments on the proposed regulations and the principal revisions made in the final regulations are discussed below.

Explanation of Provisions

This Treasury decision contains final regulations to the Income Tax Regulations under sections 62(c), 132(d), and 274 of the Internal Revenue Code (Code) to reflect changes made to section 274 of the Code by sections 13209, 13210, and 13272 of OBRA (107 Stat. 469, 542). The OBRA provisions amended section 274 of the Code by (1) limiting the deductible

portion of meal and entertainment expenses to 50 percent; (2) eliminating the deduction for club dues; and (3) restricting the deduction for spousal travel. The amendments to the regulations under sections 62 and 132 of the Code concern the income tax consequences to employees when their employer's (or third party payor's) deduction is disallowed by the amendments to section 274 of the Code.

Comments to the proposed regulations concerned whether payment of expenses for club dues and spousal travel by an employer exempt from taxation under subtitle A of the Internal Revenue Code were eligible for the working condition fringe exclusion. The final regulations provide that any reference in the regulations to an employer's deduction disallowed by sections 274(a)(3) or 274(m)(3) of the Code will be treated as a reference to the amount which would be disallowed as a deduction to the employer if the employer were not exempt from taxation.

Other comments suggested that the final regulation extend the section 274(e)(2) option of an employer to avoid the section 274 disallowance for payment of spousal travel to persons who pay expenses described in section 274(e)(9). To achieve consistent results for payments to independent contractors and employees with respect to spousal travel, the final regulations adopted this suggestion.

A number of comments requested clarification of the term *other individual* in section 274(m)(3). In particular, the comments asked that the term be clarified so as not to preclude the deduction for travel expenses of a business associate accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel. The regulation was amended to reflect these comments.

One comment concerned the person to whom a fringe benefit is taxable. The rules concerning to whom a fringe benefit is taxable are set forth in §1.61-21(a)(4). For rules concerning volunteers, see §1.132-5(r).

Several comments involved the amount of the employer's disallowed deduction when the expenses of a spouse, dependent, or other individual accompanying an employee on a non-

Section 274.—Disallowance of Certain Entertainment, Etc., Expenses

26 CFR 1.274-1: Disallowance of certain entertainment, gift and travel expenses.

T.D. 8666

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1**

Payment by Employer of Expenses for Meals and Entertainment, Club Dues, and Spousal Travel.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations

SUMMARY: This document contains final regulations relating to reimbursement and other expense allowance arrangements for expenses of business meals and entertainment that are dis-

commercial flight qualify as a working condition fringe benefit. This issue is under further consideration. In addition, other comments requested clarification of what constitutes a deductible expenditure for spousal travel under the general rule of section 162(a). The rules for deducting travel expenses of a spouse are in §1.162-2(c).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are David N. Pardys, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), and John T. Sapienza, Jr., Office of the Assistant Chief Counsel (Income Tax and Accounting), IRS. Personnel from other offices of the IRS and Treasury Department also participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.62-2, paragraph (h)(1) is amended by adding a second sentence at the end of the paragraph to read as follows:

§1.62-2 Reimbursements and other expense allowance arrangements.

* * * * *

(h) * * * (1) * * * If an arrangement provides advances, allowances, or reimbursements for meal and entertainment expenses and a portion of the payment is treated as paid under a nonaccountable plan under paragraph (d)(2) of this section due solely to section 274(n), then notwithstanding paragraph (h)(2)-(ii) of this section, these nondeductible amounts are neither treated as gross income nor subject to withholding and payment of employment taxes.

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Par. 3. In §1.132-5, paragraphs (s) and (t) are added to read as follows:

§1.132-5 Working condition fringes.

* * * * *

(s) *Application of section 274(a)-(3)—(1) In general.* If an employer's deduction under section 162(a) for dues paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose is disallowed by section 274(a)(3), the amount, if any, of an employee's working condition fringe benefit relating to an employer-provided membership in the club is determined without regard to the application of section 274(a) to the employee. To be excludible as a working condition fringe benefit, however, the amount must otherwise qualify for deduction by the employee under section 162(a). If an employer treats the amount paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose as compensation under section 274(e)(2), then the expense is deductible by the employer as compensation and no amount may be excluded from the employee's gross income as a working condition fringe benefit. See §1.274-2(f)(2)(iii)(A).

(2) *Treatment of tax-exempt employers.* In the case of an employer exempt from taxation under subtitle A of the Internal Revenue Code, any reference in this paragraph (s) to a deduction disallowed by section 274(a)-(3) shall be treated as a reference to the amount which would be disallowed as a deduction by section 274(a)(3) to the employer if the employer were not exempt from taxation under subtitle A of the Internal Revenue Code.

(3) *Examples.* The following examples illustrate this paragraph (s):

Example 1. Assume that Company X provides Employee B with a country club membership for which it paid \$20,000. B substantiates, within the meaning of paragraph (c) of this section, that the club was used 40 percent for business purposes. The business use of the club (40 percent) may be considered a working condition fringe benefit, notwithstanding that the employer's deduction for the dues allocable to the business use is disallowed by section 274(a)(3), if X does not treat the club membership as compensation under section 274(e)(2). Thus, B may exclude from gross income \$8,000 (40 percent of the club dues, which reflects B's business use). X must report \$12,000 as wages subject to withholding and payment of employment taxes (60 percent of the value of the club dues, which reflects B's personal use). B must include \$12,000 in gross income. X may deduct as compensation the amount it paid for the club dues which reflects B's personal use provided the amount satisfies the other requirements for a salary or compensation deduction under section 162.

Example 2. Assume the same facts as *Example 1* except that Company X treats the \$20,000 as compensation to B under section 274(e)(2). No portion of the \$20,000 will be considered a working condition fringe benefit because the section 274(a)(3) disallowance will apply to B. Therefore, B must include \$20,000 in gross income.

(t) *Application of section 274(m)-(3)—(1) In general.* If an employer's deduction under section 162(a) for amounts paid or incurred for the travel expenses of a spouse, dependent, or other individual accompanying an employee is disallowed by section 274(m)(3), the amount, if any, of the employee's working condition fringe benefit relating to the employer-provided travel is determined without regard to the application of section 274(m)(3). To be excludible as a working condition fringe benefit, however, the amount must otherwise qualify for deduction by the employee under section 162(a). The amount will qualify for deduction and for exclusion as a working condition fringe benefit if it can be adequately shown that the spouse's, dependent's, or other accompanying individual's presence on the employee's business trip has a bona fide business purpose and if the employee substantiates the travel within the meaning of paragraph (c) of this section. If the travel does not qualify as a working condition fringe benefit, the employee must include in gross income as a fringe benefit the value of the employer's payment of travel expenses with respect to a spouse, dependent, or other individual accompanying the

employee on business travel. See §§1.61-21(a)(4) and 1.162-2(c). If an employer treats as compensation under section 274(e)(2) the amount paid or incurred for the travel expenses of a spouse, dependent, or other individual accompanying an employee, then the expense is deductible by the employer as compensation and no amount may be excluded from the employee's gross income as a working condition fringe benefit. See §1.274-2(f)(2)(iii)(A).

(2) *Treatment of tax-exempt employers.* In the case of an employer exempt from taxation under subtitle A of the Internal Revenue Code, any reference in this paragraph (t) to a deduction disallowed by section 274(m)(3) shall be treated as a reference to the amount which would be disallowed as a deduction by section 274(m)(3) to the employer if the employer were not exempt from taxation under subtitle A of the Internal Revenue Code.

Par. 4. The last sentence of §1.274-1 is revised to read as follows:

§1.274-1 Disallowance of certain entertainment, gift and travel expenses.

*** For specific provisions with respect to the deductibility of expenditures: for an activity of a type generally considered to constitute entertainment, amusement, or recreation, and for a facility used in connection with such an activity, as well as certain travel expenses of a spouse, etc., see §1.274-2; for expenses for gifts, see §1.274-3; for expenses for foreign travel, see §1.274-4; for expenditures deductible without regard to business activity, see §1.274-6; and for treatment of personal portion of entertainment facility, see §1.274-7.

Par. 5. Section 1.274-2 is amended as follows:

1. The section heading for §1.274-2 is revised.
2. In paragraph (c)(6), a second sentence is added at the end of the paragraph.
3. The paragraph heading for paragraph (f)(2)(i) is revised.
4. Paragraph (f)(2)(iii) is revised.
5. Paragraph (g) is added.

The revised and added provisions read as follows:

§1.274-2 Disallowance of deductions for certain expenses for entertainment, amusement, recreation, or travel.

* * * * *

(c) * * *

(6) * * * This paragraph (c)(6) applies to club dues paid or incurred before January 1, 1987.

* * * * *

(f) * * *

(2) * * *

(i) *Business meals and similar expenditures paid or incurred before January 1, 1987—* * * *

* * * * *

(iii) *Certain entertainment and travel expenses treated as compensation—(A) In general.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) or for travel described in section 274(m)(3), if an employee is the recipient of the entertainment or travel, is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent that the expenditure is treated by the taxpayer—

(1) On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and

(2) As wages to the employee for purposes of withholding under chapter 24 (relating to collection of income tax at source on wages).

(B) *Expenses includible in income of persons who are not employees.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith), or for travel described in section 274(m)(3), is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent the expenditure is includible in gross income as compensation for services rendered, or as a prize or award under section 74, by a recipient of the expenditure who is not an employee of the taxpayer. The preceding sentence shall not apply to any amount paid or incurred by the taxpayer if such amount is required to be included (or would be so required except that the amount is less than \$600) in any information return filed by such taxpayer under part III of subchapter A of chapter 61 and is not so included. See section 274(e)(9).

(C) *Example.* The following example illustrates the provisions this paragraph (f):

Example. If an employer rewards the employee (and the employee's spouse) with an expense paid vacation trip, the expense is deductible by the employer (if otherwise allowable under section 162 and the regulations thereunder) to the extent the employer treats the expenses as compensation and as wages. On the other hand, if a taxpayer owns a yacht which the taxpayer uses for the entertainment of business customers, the portion of salary paid to employee members of the crew which is allocable to use of the yacht for entertainment purposes (even though treated on the taxpayer's tax return as compensation and treated as wages for withholding tax purposes) would not come within this exception since the members of the crew were not recipients of the entertainment. If an expenditure of a type described in this subdivision properly constitutes a dividend paid to a shareholder or if it constitutes unreasonable compensation paid to an employee, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Internal Revenue Code.

* * * * *

(g) *Additional provisions of section 274—travel of spouse, dependent or others.* Section 274(m)(3) provides that no deduction shall be allowed under this chapter (except section 217) for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel, unless certain conditions are met. As provided in section 274(m)(3), the term *other individual* does not include a business associate (as defined in paragraph (b)(2)(iii) of this section) who otherwise meets the requirements of sections 274(m)(3)(B) and (C).

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved March 26, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 29, 1996, 8:45 a.m., and published in the issue of the Federal Register for May 30, 1996, 61 F.R. 27005)

Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275-4: Contingent payment debt instruments.

The Service will not issue rulings or determination letters for state-created prepaid tuition

plans, including whether any contract under the plan is a debt instrument and, if so, how original issue discount attributable to the contract is treated for federal tax purposes. See Rev. Proc. 96-34, page 14.
